

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Dutton Analyst: Darrine Distefano Bill Number: AB 2398
Related Bills: See Legislative History Telephone: 845-6458 Amended Date: May 3, 2004
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Employer Hiring Credit

SUMMARY

This bill would provide a hiring credit to employers.

SUMMARY OF AMENDMENTS

The May 3, 2004, amendments delete Legislative intent language to revise the Revenue and Taxation Code (R&TC) in a manner that would stimulate job growth and insert the provisions discussed in this analysis.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to stimulate the growth of small businesses and encourage job growth in areas that are under economic stress.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The credit would apply to taxable years beginning on or after January 1, 2005, and before January 1, 2010.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing federal and state laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business (e.g., including employee wages and benefits).

Existing state law provides various tax credits that are designed to provide tax relief for taxpayers who must incur certain expenses (e.g., renter's credit) or to influence behavior, including business practices and decisions (e.g., research credits). For instance, taxpayers who pay someone to care for their child so they can work are allowed a child and dependent care credit based on those expenses and the taxpayer's income.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Will Bush for Gerald H. Goldberg

5/14/04

Under the R&TC, existing state law provides a hiring credit for taxpayers conducting business activities within an Enterprise Zone (EZ), Local Agency Military Base Recovery Area (LAMBRA), Targeted Tax Area (TTA), and a Manufacturing Enhancement Area (MEA), collectively known as economic development areas (EDAs). A qualified employee must be hired after the area is designated an EDA and meet certain other criteria. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on the EDA income.

THIS BILL

This bill would allow a credit for wages paid to a qualified employee by the employer. The credit would be available to the employer for the first five years of the qualified employee's employment. The credit percentage would be:

- 50% of the qualified wages for the first year of employment.
- 40% of the qualified wages for the second year of employment.
- 30% of the qualified wages for the third year of employment.
- 20% of the qualified wages for the fourth year of employment.
- 10% percent of the qualified wages for the fifth year of employment.

This bill defines the following terms:

- "Qualified wages" is a portion of wages paid or incurred by a qualified employer during the taxable year to a qualified employee that does not exceed 150% of the minimum wage, as defined.
- "Minimum wage" is the wage established by the Industrial Welfare Commission.
- "Qualified employee" is a person who is initially employed by a qualified employer on or after January 1, 2005. It does not include a person who was initially employed after January 1, 2005, terminated, and then re-employed by the taxpayer.
- "Qualified employer" is an employer that meets the following criteria:
 - The principal office is located in California.
 - The principal office is not located in any of the following areas: EZ, MEA, TTA, or LAMBRA.

This bill would allow any unused credit to be carried over until exhausted.

This bill specifies any deduction allowed for wages paid or incurred would be reduced by the amount of any credit allowed.

IMPLEMENTATION CONSIDERATIONS

This bill does not specify how long an employee must be employed for a taxpayer to qualify for the credit. As written, a taxpayer only has to hire an employee for one day after January 1, 2005, in order to claim the credit, although since the credit base is the amount of qualified wages, up to 150% of the minimum wage, the actual credit in such a situation would be rather small. The author may wish to add a minimum term employment requirement for the taxpayer to be able to qualify for the credit. Finally, it is not clear if a seasonal or leased employee would qualify the taxpayer for the credit.

This bill does not limit the credit for a taxpayer with multiple affiliated entities since the prohibition on termination and subsequent rehiring of an employee only applies to the taxpayer, and not to other members that have similar business operations under the control of a single owner. As a result, a taxpayer could transfer or rotate an employee between affiliates and claim a credit for each transfer or rotation. The author may wish to add language that limits an employee to count once.

This bill uses the term “principal office” to determine whether an employer is qualified. It is not clear if this term means the location of an employer’s headquarters or the location of where the trade or business is performed. Since the intent of this bill is to limit the credit to employers outside an EDA, the author may wish to use the term “trade or business” instead to eliminate confusion for the employer and the department.

This bill does not limit the number of years for the carryover period. Without a limit the department would be required to retain the carryover on the tax forms indefinitely because presently the bill would allow an unlimited credit carryover period. Recent credits have been enacted with a carryover limitation since experience shows credits are typically used within eight years of being earned.

LEGISLATIVE HISTORY

SB 1523 (Ashburn, 2003/2004) would allow a hiring credit to employers with fewer than 19 employees. This bill is currently in the Senate Appropriations Committee.

SB 1876 (Alpert, 2003/2004) would, have among other things, created a Living Wage Opportunity and Revitalization Credit and repeal the EDA hiring credits. SB 1876 was amended on April 29, 2004, to be a California earned income tax credit. This bill is currently in the Senate Appropriations Committee.

AB 2365 (Correa, 2003/2004) would allow a credit for wages paid to a qualified employee who is hired in the taxpayer’s manufacturing trade or business. This bill is currently in the Assembly Revenue & Taxation Committee.

AB 475 (Cogdill, 2001/2002) would have allowed a small business that is located in a qualified area a credit based on employees' wages. This bill failed passage in the Assembly Revenue & Taxation Committee.

SB 2010 (Hurt, 1995/1996) would have allowed a credit equal to an unspecified percentage of qualified minimum wages that were paid or incurred by an employer. This bill failed passage in the Senate Revenue and Taxation Committee.

OTHER STATES’ INFORMATION

Florida allows businesses located in an EZ a credit based on wages paid to new employees. Other wage-based credits are offered to businesses that are located in high crime areas or in rural areas.

New York allows a wage credit to a business that hires a full time employee (either one in targeted group or not) for a newly created job in an Empire Zone.

Illinois, Massachusetts, Michigan, and Minnesota do not offer a wage credit to small business employers.

Most of these states offer assistance such as financial, marketing, licensing, finding employees, taxes seminars, and training to small businesses.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

It is estimated that revenue losses for the initial three fiscal years impacted by this bill are as follows:

Employment Hiring Credit Proposal (\$ In Billions)			
Fiscal Year	2004/2005*	2005/2006	2006/2007
Net Revenue Loss	-0.1	-1	-2

* The 2004-05 estimate reflects the fact that some businesses would reduce estimated tax payments over the first half of 2005.

Revenue Discussion

Using Employment Development Department Labor Market Information, it is projected that California's private sector labor force would equal roughly 12 million individuals in tax year 2005. Assuming a 3% turnover (per Bureau of Labor Statistics) amongst all businesses, approximately 360,000 individuals would commence employment with a new employer in 2005.

Although the term "principal office" is not defined, it appears the intent of this bill is to disqualify employers with headquarters located out-of-state from claiming this credit. Based on historical multi-state tax return data, 1 in 5 large employers have headquarters in California. This suggests that 36% of the potential new hires or 130,000 new jobs per year, in the state labor force would not qualify their employer for this credit.

Based on the demographical data for existing EZs, it is projected that 4% of the labor force is working for an employer with a principal office in an existing EDA. This amounts to roughly 15,000 new jobs per year disqualified due to this second category of disqualified employers. Combined with the 130,000 new jobs per year projected for disqualified out-of-state employers, it is estimated that 145,000 (130,000 plus 15,000) of the 360,000 projected new jobs would be for disqualified employers. The remaining 215,000 (360,000 minus 145,000) individuals would qualify their employer for this credit beginning in the year 2005.

To account for varying levels of employment duration, this estimate assumes each qualified worker is employed for 1,500 hrs/year earning wages of up to \$10.13/hr (1500 X \$10.13 = \$15,195). Using an average wage per class for the segment of the labor force earning less than 150% of minimum wage, plus a value of \$10.13/hr for all new hires earning more than this fixed dollar amount, it is estimated that a total of \$3 billion (\$15,195 X 215,000 individuals) of qualified wages would be paid in 2005.

The amount of qualified wages is used to compute *allowable credits*, using a declining scale percentage of 50% in year one, reduced 10% per year for the next four years of employment. The tax effect of the wage expense deduction offset to the projected revenue loss is equal to 8% (effective tax rate) of the qualified wages. Based on the above discussion and allowing for the fact that some employers would not have sufficient tax liabilities to fully apply credits, an estimated \$1 billion revenue loss ($\$3 \text{ billion} / 50\% = \$1.5 \text{ billion} \times 8\%$) is likely to occur in the first full fiscal year (2005-06), with revenue losses increasing significantly thereafter.

ARGUMENTS/POLICY CONCERNS

This bill would require the taxpayer to reduce any wage deduction by the amount of credit taken. This would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same item of expense.

This credit would be limited to an employer whose principal office is located in California. Although the principal office could be the location of where the operation is managed, not where the work is performed, restrictions based on the location of a business could be subject to challenge as unconstitutional discrimination in favor of local commerce.

This bill does not restrict the wage credit to employees who are employed within California (and are thus themselves subject to California tax on their earnings).

LEGISLATIVE STAFF CONTACT

Darrine Distefano
Franchise Tax Board
845-6458
darrine.distefano2@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov

